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C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 000854

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SUBJECT: LONG-FEARED GAS CRUNCH GIVES WAY TO GAS GLUT

REF: A. MOSCOW 367
¶B. 08 MOSCOW 3321
¶C. 07 MOSCOW 875
¶D. DOHA 224

Classified By: Econ MC Eric T. Schultz for Reasons 1.4 (b/d)

Summary

¶1. (SBU) The long-feared Russian "gas crunch" -- an inability to meet domestic and export gas commitments (ref C) -- has given way to a veritable "gas glut" as European and domestic gas demand plummets. As a consequence of the sharp recession in Russia, domestic demand over the next several years could be between 30 and 50 bcm less per year than had been expected. EU demand is likely to be down similarly. The immediate impact of these new dynamics has been lower Russian gas sales and production, and, unfortunately, increased Gazprom protection of its pipeline monopoly. The medium-term impact of the gas glut on Russia will likely be two-fold: less urgency for Russia's planned additional gas pipelines but also reduced pressure on Gazprom to invest in future production. The downward shift in demand coupled with massive new volumes of LNG on the world market (ref D) could dramatically alter the back-drop of Russia-EU gas relations. End summary.

PLUMMETING DEMAND...

¶2. (SBU) In a recent presentation, gas expert Tatiana Mitrova noted that gas demand in Russia in December of 2008 was down over 30% year-on-year in response to plummeting industrial production, especially in gas-intensive industries. Mitrova calculated that domestic gas demand, which accounts for about 75% of Gazprom's sales by volume, will be between 30 and 50 billion cubic meters (bcm) per year lower through 2013 than was previously forecast by the GOR and could remain below forecast levels for years longer.

¶3. (U) Mitrova noted that the export side could see similarly reduced demand as industrial production in the CIS, especially in Ukraine, crashes, and EU consumption falls well below earlier forecasts. In her presentation, she showed how the European Commission Directorate General for Transportation and Energy (DG TREN) forecasts for gas EU gas demand in 2020 have been revised downward each year. The forecast demand for 2020 has fallen from the nearly 700 bcm

predicted in 2006, to less than 650 bcm in 2007, to just over 550 bcm forecast in 2008 -- and those figures do not yet fully account for the effects of the financial and economic crisis. They also do not account for the EC's "New Energy Policy," which, if successful, could result in natural gas demand shrinking, not growing, by 2020, according to EC forecasts.

¶4. (C) Press reports indicate that Gazprom's exports to non-CIS Europe could be down as much as 50% in the first quarter of 2009, with the January gas crisis accounting for only about one-fifth of that drop. Those figures may, however, be over-stating the real reduction in demand. ExxonMobil Russia Gas Marketing V.P. Peter Lundh explained to us on March 27 that the "alarming" numbers reported for January and February are largely due to European consumers deliberately taking the absolute minimum gas required, knowing that prices, which reached their peak in January and February, would soon plunge. Lundh said consumers who were able to do so pursued efficiencies and switched to gas from storage or alternative fuel sources. That said, Lundh agreed that the fundamental gas demand picture going forward has shifted substantially downward along with the global economic outlook.

...COUPLED WITH INCREASED SUPPLY

¶5. (SBU) As reported in refs A and D, the drop in EU demand coincides with a worldwide surge in LNG production. In a

recent presentation by Tim Lambert of the energy consulting firm Wood Mackenzie, much of this new LNG will be sold to the European market. Lambert explained that the U.S. had been expected to absorb much of the new LNG supply over the next several years. However, Lambert said, the combination of reduced U.S. demand and increased domestic production means that the U.S. simply doesn't need the gas anymore, and it will instead find its way to Europe, further reducing demand for Russian gas.

...TURNS EXPECTED GAS "CRUNCH" INTO GAS GLUT

¶6. (U) Analysts had long worried that increasing European gas demand coupled with a booming Russian economy and a lack of needed investments on the part of Gazprom would lead to Russia being unable to meet its domestic and export gas commitments (ref C) -- the so-called coming gas "crunch." However, Mitrova's and others' forecasts for substantially lower gas demand in Russia, Europe, and the CIS mean that overall gas demand in Gazprom's markets could be 200 bcm (or more) lower in 2020 than predicted just a few years ago. Combined with new LNG supplies from the Middle East and elsewhere, this stunning reversal in the demand picture has now created, at least in the short- and medium-term, a veritable gas glut.

IMMEDIATE IMPACT ON PRODUCTION AND SALES

¶7. (SBU) The changing demand dynamics have already had immediate impacts on Gazprom and the Russian gas sector. Gazprom has begun to shut down some production. According to press reports, Gazprom's production at the end of March was 30% lower than in March of last year -- a figure analysts noted is less than Gazprom produces in the slow summer months. Analysts have also suggested that in order to keep up its own domestic production, Gazprom could limit its imports of Central Asian gas. However, Gazprom's Sergei Komlev, Director of Contract Structuring, told a conference on March 26 that the company would fulfill its contracts to

buy Central Asian gas, even it must do so at a loss.

¶8. (SBU) Lowered gas demand has also had a very significant impact on Gazprom's finances (ref A). On March 31, Gazprom Deputy CEO Alexander Medvedev told reporters that the company now expects exports to Europe in 2009 to total just 140 bcm, down from 179 bcm last year, and down 30 bcm from Gazprom's February estimate of 170 bcm for the year. In March, Gazprom also reduced its average 2009 European price forecast from $280 per thousand cubic meters (mcm) to just $260 per mcm, down from $409 per mcm in 2008. The revised export volumes and revised export price mean that in just the past month Gazprom has reduced the expected value of its gas sales to Europe by an additional $7.8 billion on top the already expected $26 billion drop in export sales over 2008. Even those figures could be optimistic. Alfa Bank chief strategist Ron Smith told us March 31 that he believes the average 2009 price to Europe will be closer to $210 per mcm.

MEDIUM AND LONGER-TERM IMPLICATIONS

¶9. (C) Lower demand and reduced Gazprom revenues have unfortunately resulted in Gazprom imposing even greater restrictions on third-party access to its pipeline system (ref B). Gazprom has publicly stated it expects third-party suppliers to reduce their production and their inputs into Gazprom's pipelines. TNK-BP CEO Tim Summers (protect) told us recently that the reduction requests from Gazprom are not proportional. He feared Gazprom would try to shut out third-party suppliers completely, forcing them to significantly reduce production and accept steep financial costs.

¶10. (SBU) The gas glut could have two important longer-term effects as well. According to industry experts, the current excess supply of gas should allow Gazprom some breathing room with regard to multi-billion dollar investments needed to

maintain its current production levels. Mitrova noted that while the company was moving ahead with its plans for its Yamal fields, other projects, such as the Shtokman field in the Barents Sea, could wait for clearer signals from the market.

¶11. (SBU) The new dynamics of the supply and demand picture should also reduce the urgency on the part of Gazprom and the GOR to push ahead with various pipeline plans, including Nord Stream and South Stream. Using 2005 forecasts in a 2007 presentation to us, Nord Stream executives had confidently noted that the pipeline would only fill a fraction of projected European gas demand, which they said would rise from 570 bcm in 2005 to 712 bcm in 2015.

¶12. (SBU) Nord Stream's 2009 presentation more accurately reflects the current realities, and uses a forecast of 629 bcm of European demand by 2025 (83 bcm lower and 10 years later than the earlier version). Lower demand, however, will not mitigate the desire on the part of the GOR to diversify routes and reduce its transit dependence on Ukraine. This could partly explain why, despite the new demand picture, we have not seen evidence that the GOR intends to alter its pipeline ambitions, particularly with respect to Nord Stream.

COMMENT

¶13. (C) The most important implication of a gas glut could be reduced Russian influence over its neighbors and the EU. While Russian gas exports to the EU may still rise in the coming decade (as domestic EU production declines), the back-drop of Russia-EU gas relations may shift dramatically. The scenarios that saw Russia holding the EU hostage to

Russian gas, with insatiable demand from the EU hitting a wall of limited Russian supply, now seems far less likely to come to pass. In fact, the opposite may be true -- increased access to LNG and lower demand in Russia, the CIS, and Europe may in fact give the EU the upper hand in gas negotiations with Russia.

BEYRLE